Linklaters

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EU “gets tough” on market abuse.

Overview

The European Commission has published a draft of a new Market Abuse Regulation, which will replace existing EU and UK law on:

> market abuse;

> disclosure of inside information to the market;

> insider lists; and

> disclosure of own account transactions by persons discharging managerial responsibilities.

It has also published proposals for a Directive requiring Member States to impose criminal sanctions for serious cases of insider dealing and market manipulation.

The Regulation and the Criminal Sanctions Directive are subject to completion of the legislative process and the likely effective date will be some time in 2014. The Regulation will be supplemented by EU-wide secondary legislation and technical standards which have not yet been published. Until such time as those supplementary materials are released, there will remain significant uncertainty as to how the Regulation will impact current practice.

The key changes of interest to UK companies and market participants are:

> a broader definition of inside information for market abuse purposes so that there is a distinction between the type of information that restricts trading and the information which issuers have to disclose;

> increased regulation of trading in commodity-related derivatives and emissions allowances;

> the rules will apply to new trading facilities (multilateral trading facilities and “organised trading facilities”), commodities markets and emissions market participants;

> a requirement for suspicious orders to be reported, in addition to suspicious transactions; and

> tough enforcement powers for competent authorities such as the Financial Services Authority, including criminal sanctions.

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Insider dealing and improper disclosure

Lowering the bar

Currently, the Market Abuse Directive (2003/6/EC) (MAD) applies the same definition of inside information for all purposes. The Regulation proposes to introduce a broader definition for the purpose of the market abuse offences of insider dealing and improper disclosure as opposed to the definition that will apply in relation to an issuer's obligation of disclosure to the market.

As at present, issuers' disclosure obligations will apply to unpublished information relating to them or their securities which is:

> of a precise nature; and

> likely to have a significant effect on price. This is itself defined as information a reasonable investor would be likely to use as part of the basis of its investment decision.

However, in relation to the offences of insider dealing and improper disclosure, there will be no need for information to be precise. Instead any information which would be regarded by a reasonable investor as relevant when deciding the terms on which to effect transactions in the relevant instruments will constitute inside information for those offences.

Although the concept of relevant information which is not generally available (RINGA) already exists in the UK market abuse provisions (Section 118(4) Financial Services and Markets Act 2000), the FSA's Code of Market Conduct clarifies that it only applies to precise information of a kind that is disclosable, and an offence is only committed if the behaviour falls below the standard that would be expected by a regular user of the market.

The extension of the definition of inside information to non-precise information raises a number of concerns, particularly in the absence of the regular market user test and the guidance that is contained in the Code of Market Conduct. An issuer's obligation to disclose inside information will not extend to the broader category of "relevant information" (see further *Disclosing inside information to the market* below). Therefore, once someone comes into possession of relevant information, unless it is information which will, at a later stage, become precise such that it is disclosed to the market, they may never be "cleansed" of it, so that there will be significant uncertainty as to when they may begin dealing again.

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Important examples of behaviour which is permitted under the MAD but on which the Regulation is silent include:

> using inside information in the context of a public takeover bid;

> carrying out your own prior decision to buy or sell;

> market-makers pursuing their legitimate business of buying or selling financial instruments; and

> legitimate execution of client orders.

The definition of inside information is also extended to include information in respect of spot commodity contracts related to derivatives on commodities and information relating to emissions allowances. This new provision (together with the extension of market manipulation to cover such instruments) has to be considered alongside the market abuse provisions relating to electricity and natural gas derivatives and other wholesale energy products in the Regulation on wholesale energy market integrity and transparency, adopted by the Council on 10 October 2011 following a first reading agreement with the European Parliament, and in relation to spot and futures contracts in emissions allowances, Regulation 1031/2010.

We will look further at the commodity-specific aspects of the Regulation with a view to producing a separate briefing on those matters.

I have, therefore I use?

The Regulation maintains the concept from the MAD that insider dealing occurs when an insider who is in possession of inside information "uses that information by acquiring or disposing of … financial instruments to which that information relates". In the UK, the requirement to "use" inside information has been implemented so as to prohibit dealing "on the basis of" inside information. The Code of Market Conduct gives guidance on the meaning of "on the basis of" to clarify when dealing while in possession of inside information will not constitute insider dealing.

"It will be essential to provide clear safe harbours for specified activities"

In the *Spector* case (*Spector Photo Group NV, Chris Van Raemdonck v Commissie voor het Bank, Financie- en Assurantiewezen (CBFA) C-45/08*), the European Court of Justice ruled that an insider "in possession of" inside information could be presumed to have "used" that information when dealing in investments to which the information relates, although it might be possible to rebut that presumption on a case-by-case basis with reference to the purpose of the MAD to protect the integrity of the financial markets and investor confidence.

This approach has created uncertainty and it is unfortunate that the opportunity has not been taken in the Regulation to clarify the intention of this language. It will be essential for the EU to provide clear safe harbours for specified activities, for example by stating that it will not be insider dealing where the decision to deal was taken in advance of receiving the inside information.

The Regulation is clear that it does not constitute insider dealing for one division of a company to deal just because the other division has inside information, provided there are effective arrangements in place (Chinese walls) to ensure that nobody in possession of inside information has any involvement in or influence over the dealing decision. However, the Regulation introduces a new requirement that "effective arrangements" must ensure that there is "*no contact with those involved in the decision whereby the information could have been transmitted or its existence could have been indicated*". This appears to mean that, for example, if individuals with inside information share the same lifts in their building as those who may be dealing, the information barrier defence may not apply.

Attempted market manipulation

Attempted market manipulation will be prohibited under the Regulation, in addition to actual market manipulation. This is intended to capture those people who try to manipulate the market but do not succeed (for example, if someone tries to place a manipulative order through their broker but the broker refuses).

Prevention and detection

Any person professionally arranging or executing trades in financial instruments (i.e. brokers) must have systems in place to detect and report transactions which might constitute market abuse. The suspicious transaction reporting regime is being extended so that brokers must report suspicious orders, as well as suspicious transactions, to the competent authority without delay. This will ensure that any unsuccessful orders which might amount to attempted market manipulation will be reported. For brokers, there will be an initial extra cost and administrative burden in changing their reporting systems and procedures.

Disclosure requirements

Disclosing inside information to the market

The Regulation will continue to require issuers to disclose inside information directly concerning them to the public as soon as possible, subject to a limited ability to delay disclosure so as not to prejudice the issuer's legitimate interests. Key changes to the rules on public disclosure of inside information are:

- if an issuer has delayed disclosure, it must, once it has announced the information, inform the competent authority (in the UK, the FSA) that the disclosure was delayed. The aim of this new obligation is to ensure companies focus on the need to meet certain conditions before disclosure can be delayed (i.e. that the omission is not likely to mislead the public and the confidentiality of the information can be maintained); and
- there is a new power for competent authorities to permit delay of disclosure of inside information which is "of systemic importance" if it is in the public interest to delay its publication and confidentiality can be ensured. This could be useful, for instance, in relation to measures to save a failing financial institution.

The test for disclosure under the Regulation is that the information must be both precise and "likely to have a significant effect on price", which means information a reasonable investor would be likely to use as part of the basis of his investment decisions. The inclusion of the second limb of the definition will perpetuate the significant uncertainty that exists under the MAD as to whether it means:

- inside information must be both price-sensitive *and* likely to be used by a reasonable investor; or

> it is enough for information to be likely to be used by a reasonable investor for it to be inside information, without it being necessary to establish that the information was likely to have a significant effect on price.

Insider lists

Issuers will still have to compile insider lists. The harmonisation of rules on insider lists across the EU should reduce administrative burdens and costs for companies with more than one listing of their shares, but the detailed rules will be contained in ESMA technical standards.

Emission allowance market participants

Emission allowance market participants will be obliged to keep insider lists and to inform the public of inside information concerning emission allowances which they hold in respect of their business in the same way that issuers of financial instruments must disclose information to the market. However, there will be an exemption for emissions allowance market participants if the installations or aviation activities they own, control or are responsible for have had emissions and rated thermal inputs over the past year which do not exceed a minimum threshold. That threshold will be set by secondary legislation.

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PDMR transactions

Persons discharging managerial responsibilities and “persons closely associated to them” will continue to be required to disclose transactions conducted on their own account in shares or derivatives or other financial instruments linked to them and this obligation will extend to PDMRs within emission allowance market participants. The Regulation confirms that transactions to be notified include the pledging or lending of financial instruments and transactions undertaken by a portfolio manager on behalf of a PDMR or connected person.

However, there is a new *de minimis* threshold so that the disclosure requirement does not apply to transactions totalling under €20,000 per calendar year. PDMRs may welcome the fact that no disclosure will be needed if they only make small transactions over the year but there will be an additional administrative burden in keeping tally of undisclosed transactions so that they know when they exceed the threshold. Announcements must be made within two business days of the transaction (DTR 3.1.2 currently allows four business days).

ESMA technical standards will set out the finer details as to the exact information which must be made public, which persons will be “closely associated to” a PDMR and the means of informing the public.

None of these changes will affect the current requirements for PDMRs in the UK to obtain clearance to deal under the Model Code appended to Listing Rule 9.

Regulation of new markets, trading facilities and instruments

The existing market abuse rules apply to financial instruments admitted to trading on regulated markets. Given the greatly increased volumes of trading carried out on multilateral trading facilities and other trading facilities, such as swap execution facilities, the Regulation extends the scope of the market abuse framework. It will apply to other financial instruments if they are admitted to trading on an MTF or organised trading facility (OTF) and any related financial instruments traded over the counter (such as credit default swaps) which can impact the underlying market. The extension of the market abuse regime to OTFs will coincide with the measures, also published today, which will amend the Markets in Financial Instruments Directive (MiFID II), and which are likely to result in a significant increase in the number of derivatives traded on OTFs.

"The extension of the market abuse regime to new trading facilities will coincide with MiFID II"

However, the requirements to publicly disclose inside information and to maintain insider lists only apply to issuers who have requested or approved admission of their financial instruments to the relevant market or facility – not those whose instruments are traded without their involvement.

The Regulation also contains various exceptions in order to reduce the burden on issuers who only have financial instruments trading on an SME growth market (specialist markets that aim to cater for the needs of smaller and medium sized issuers and meet certain criteria to register as SME growth markets under MiFID II).

Enforcement

Competent authorities, such as the FSA in the UK, will continue to be responsible for enforcing breaches which occur in their territory or on markets or facilities operating within their territory. The Regulation will require competent authorities to have minimum powers to impose administrative measures, sanctions and fines of up to 10% of an entity's annual turnover or €5,000,000 in the case of an individual. However, individual Member States will also be able to fix higher penalties.

Criminal sanctions

The Commission has also published a directive to require member states to impose criminal sanctions for insider dealing and market manipulation offences. The criminal sanctions will only apply where the offence is committed with intent and will also extend to attempted insider dealing and attempted market manipulation. There is also a requirement that inciting or aiding and abetting these offences is punishable as a criminal offence.

Member states will have to ensure that companies can be held liable for the criminal offences which have been committed for their benefit by any person who has a "leading position" in the company, or if a lack of supervision or control by such a person has made the commission of an offence possible.

This potential criminal liability for companies will increase the importance of having adequate training and procedures in place to prevent market abuse.

While the UK already has criminal sanctions for insider dealing under the Criminal Justice Act 1993, it might have to introduce further sanctions for market manipulation. Ironically, the original UK market abuse regime was brought in in order to make it easier to punish misconduct, since the criminal standard of proof made it difficult to secure convictions for the offences of insider dealing or creating a false market.

A further loss of sovereignty to the EU?

An important objective of the new regime is to implement a single market abuse rulebook across the whole EU, with less scope for national variation than results from the MAD. Currently, the MAD is implemented into national law in each Member State, supplemented by local rules or guidance. The MAD will be replaced by the new Regulation. Unlike a directive (which instructs Member States to implement certain rules into national law), an EU regulation applies directly in all Member States with no need for local implementation.

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In the UK, the MAD is implemented through the Financial Services and Markets Act 2000 and Chapters 2 and 3 of the Disclosure and Transparency Rules. These rules are supplemented by formal guidance in the FSA’s Code of Market Conduct and within the DTRs themselves. For example, the Code of Market Conduct sets out parameters within which analyst briefings in relation to new issues may be undertaken without constituting improper disclosure of inside information. The FSA’s rules and guidance will no longer apply when the Regulation comes into force. Instead, the Regulation provides for secondary legislation or “delegated acts” in certain areas and for the European Securities and Markets Authority to produce technical standards in relation to other areas.

Much of the detail which will affect day-to-day practice will be contained in these delegated acts and technical standards, and they will apply across the EU in the same way as the Regulation. We expect that ESMA will publish draft technical standards for consultation but the creation of a single set of guidelines will inevitably mean some changes of practice including, potentially, more restrictive rules in some areas.

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Secondary legislation will also replace the existing EU Buyback and Stabilisation Regulation in setting out the parameters within which share buybacks and other stabilisation activity will not be considered market abuse.

What happens next?

The Regulation and the Criminal Sanctions Directive will go through the EU legislative process, which requires them to be approved by:

> the Council of the European Union (also known as the Council of Ministers), which is the main decision-making body of the EU and is composed of representatives of the national governments of Member States; and

> the European Parliament, composed of elected members, which is the directly elected legislative arm of the EU.

After they have completed the EU legislative process the final text will be published in the Official Journal of the European Union. The Regulation will take effect across the EU two years after that publication and Member States will be required to implement the Criminal Sanctions Directive into national law at the same time. Therefore we expect the new rules to apply from some time in 2014. Between now and then, the delegated acts and technical standards necessary to complete the new framework will be published for consultation.

For now, companies do not need to take any action other than to monitor developments, respond to the expected consultations if they so wish and be prepared for a busy period in 2014, when they will need to:

> train all relevant staff on the new regime;

> update compliance manuals and procedures for disclosure of information to the market;

> update internal dealing codes; and

> ensure insider list procedures match the new rules.

The Regulation is available here and the Criminal Sanctions Directive here. Further information is available on the EU's website, here, including FAQs on emission allowance market participants, here.

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